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THE EFFECT OF THE STATIST-POLITICAL APPROACH TO INTERNATIONAL JURISDICTION OF THE INCOME TAX REGIME — THE ISRAELI CASE

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INTRODUCTION

A significant variable of every tax regime, whatever tax is concerned, is its international jurisdiction. Currently, the importance of this factor is constantly increasing because of the gradual dismantling of the political, social, and economic barriers between nations resulting from international upheavals. As discussed below, the classic approach devises the legal norms on which the international jurisdiction of the tax regime is based according to various tax policy considerations, principally those pertaining to economic efficiency, equity, and economic growth.[1]

Economic efficiency may be examined in this context from two different perspectives. The first is universal and is calculated to examine whether a particular tax regime brings about an efficient worldwide allocation of resources, thereby increasing universal welfare (hereinafter referred to as "considerations of universal efficiency"). The other perspective considers efficiency of allocation from the point of view of the State where the particular tax regime prevails, ignoring universal influences (hereinafter referred to as "considerations of national efficiency").

Considerations of equity may also be examined from these two perspectives. Should we examine how far the tax regime conforms to equitable principles in relation to all taxpayers, or only in relation to those taxpayers belonging to the State concerned?

The third set of considerations centers on economic growth and seeks to attain growth with rules for devising international jurisdiction of the income taxation regime. A government may resort to various means to encourage economic growth, one of which is the tax system. From that point of view, the rules of international jurisdiction are no different from any other norms of the tax regime which the government may employ to encourage economic growth.

A policy which supports economic growth is likely to impair the efficiency of the tax system as well as social justice inherent therein. Generally speaking, the international tax regime will take a position which creates a balance between the various factors, particularly between economic efficiency and considerations of social justice.

In this article, an additional factor is presented which influences the determination of the bounds of international jurisdiction of the tax

1. The expression "economic efficiency" implies, in the present context, efficiency in global allocation of resources in the economy, in a world in which there is tax, where such allocation will be considered more efficient the more it resembles the allocation of resources in a world without tax. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 759–60 (4th ed. 1984).

regime in every country, namely that country's statist conception in light of its political philosophy. In other words, whereas the classical approach holds that rational factors (i.e., efficiency, equity, and economic growth) influence international jurisdiction, there exists an additional factor which is not "rational" in the ordinary sense of that term, that determines international jurisdiction and is derived from that particular society's political philosophy regarding its statist conception. This article discusses this proposition using the rules governing international jurisdiction of taxation of regular income (hereafter referred to as "the income tax regime") in Israel, where the influence of statist thinking on the international tax regime is clear. Some commentators have suggested that the principles and attitudes of any society can be derived from a careful study of its tax laws.[2] The topic discussed in this article exemplifies this view. Conclusions about statist thought in Israel may be drawn from an examination of the international jurisdiction of income taxation in Israel. The Israeli statist outlook, with its emphasis on territoriality, is well-reflected in the international jurisdiction of its income taxation regime.

This article proceeds from the general to the particular, by first presenting the principles of international jurisdiction of the international taxation regime and their connection with statist thinking, and then examining the rules of international jurisdiction of income taxation in Israel and the influence of the statist conception in Israel on the formation of those rules.

From the outset, a distinction must be drawn between the topic of the international *jurisdiction* of the tax regime and other topics associated with taxation of international transactions which are focused mainly on the *burden* of the tax. Those other topics only arise after it has been established that a particular event comes within the international jurisdiction of the tax regime. This distinction is analogous to the basic framework of every tax regime which consists of the "ground floor," i.e., the base tax provisions, and the "upper floor," which includes various provisions dealing with the effective burden of taxation applicable to the transactions included in the tax base. Every tax regime consists first, of a system of norms which deals with the rules of its international jurisdiction, and second, of a further set of norms which determines the burden of tax applicable to those transactions that are within the scope of that jurisdiction. The additional set of norms which, practically speaking, determines the difference of tax burden between international

2. CAROLYN WEBBER & AARON WILDAVSKY, A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD 526–27 (1986).

transactions and local ones, includes unilateral provisions of the local law which take into account the existence of the foreign tax, as well as international conventions for avoidance of double taxation. The present article is concerned with the "ground floor" provisions, covering the question of international jurisdiction, and focusing on which tax events containing a foreign element[3] are caught within the net of the tax regime. Other topics found in the "upper floor" which affect the effective burden of tax on international transactions, will be treated to the extent that they impinge upon the question of jurisdiction.

I. Policy Aspects of the International Jurisdiction of the Income Tax Regime

A. *In General*

Every tax regime, like any other system of norms, includes, by its very nature, rules of international jurisdiction. Generally speaking, there are two basic criteria of international jurisdiction. The first is territorial jurisdiction, whereby the occurence of relevant tax events within the territory of a particular State will cause tax liability to accrue in that State. Territorial jurisdiction takes no account of the identity of the person producing the income, whether she is a local or foreign resident, a citizen of the State or a foreign citizen, or a local or a foreign corporation. This criteria of international jurisdiction is centered around source rules which determine whether particular income has been earned within a certain territory. There is no single source rule determining the geographical location of all kinds of income. Rather, there is a separate source rule for every type of income which determines the place of accrual of that income. The differences between the various source rules are derived from the nature of the income concerned and from pragmatic considerations calculated to bring about greater efficiency in

3. For the use of the term "foreign element," which is characteristic of private international law, in the field of international taxation, see 1 ALBERT V. DICEY & JOHN H.C. MORRIS, DICEY & MORRIS ON THE CONFLICTS OF LAWS 3 (Lawrence Collins ed., 10th ed. 1980); *see also* JOSEPH ISENBERGH, INTERNATIONAL TAXATION 3 (1990); GEOFFREY C. CHESHIRE & P.M. NORTH, PRIVATE INTERNATIONAL LAW 3 (10th ed. 1979) (for applicability of the term to private international law). The principal topics connected with international jurisdiction of the various tax regimes are applicable also to State, or cantonal law, in federal States. *See* MUSGRAVE & MUSGRAVE, *supra* note 1, at 510–13; JOSEPH A. PECHAM, FEDERAL TAX POLICY 278 (5th ed. 1987); Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 TAX LAW 37 (1987); Howard O. Hunter, *Federalism and State Taxation of Multistate Enterprises*, 32 EMORY L.J. 89 (1989); Note, *"Resident" Taxpayers: Internal Consistency, Due Process and State Income Tax*, 91 COLUM. L. REV. 119 (1991).

enforcement. Thus, for example, U.S. income tax law provides that the source rule for personal services is the place of performance,[4] whereas the source rule for rentals or royalties is generally the place of use.[5]

The second type of jurisdiction is personal, whereby individuals and legal entities are taxed by a particular State without regard for the territory in which the income was produced. For this purpose, there has to be a link between the taxpayer and that State which would justify imposing the tax. Such a taxpayer's income will be taxed on a worldwide basis. Most States have adopted residence as the basis for personal jurisdiction.[6] The United States is one of the few countries that have provided that citizenship can also serve as a basis for personal jurisdiction.[7] Personal jurisdiction must also define the "personal" link required of corporations to make them liable for a tax on their income on a worldwide basis. Is it sufficient for a corporation to be registered under the

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4. I.R.C. § 861(a)(3) (1988); Treas. Reg. 1.861-4(b)(2) (as amended in 1975); *see also* Karrer v. United States, 152 F. Supp. 66 (Ct. Cl. 1957); Tipton & Kalmbach v. United States, 480 F.2d 1118 (10th Cir. 1973); Stemkowsky v. Commissioner, 690 F.2d 40 (2d Cir. 1982); Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982); Boulez v. Commissioner, 83 T.C. 584 (1984). For this test in the context of conventions for preventing double taxation, see, e.g., Johanssen v. United States, 336 F.2d 809 (5th Cir. 1964).

5. I.R.C. § 861(a)(4) (1988). If the income is produced from use made outside the United States, it will be classified as income produced abroad. *Id.* § 862(a)(4). This is also the rule in South Africa. *See* Commissioner v. British United Shoe Machinery, 26 S. Afr. T.C. 163 (Fed. S.Ct. Rhodesia 1964).

6. In England, the personal link is based on three concepts: Residence, ordinary residence and domicile. England is the only developed country that makes use of domicile as a personal link for tax liability, and this aspect of the law is subject to criticism. *See* PETER WHITEMAN, WHITEMAN ON INCOME TAX 138–41 (3d ed. 1988); *The Domicile Effect*, 19 TAXATION (England) 660 (1991). In the United States, a certain degree of connection from residence as well as nationality has been adopted as a basis for tax liability by virtue of personal jurisdiction. See 1 ISENBERGH, *supra* note 3, at 45; RICHARD L. KAPLAN, FEDERAL TAXATION OF INTERNATIONAL TRANSACTION 529 (1988); Johanssen, 336 F. 2d at 809. For definition of residence of individuals in New Zealand, see W.M. Patterson & Susan R. Lamb, *Residence of Individuals and the Income Tax Amendment Act (No. 5) 1988*, 1990 NEW ZEALAND L.J. 102. In Spain, individuals and corporations are also liable to tax on a worldwide basis. *See* Isabel Menedes Ros, Income Tax Source Jurisdiction of Non-residents in Spain 7 (1990) (Unpublished manuscript on file with *International Tax Program*, Harvard Law School). For discussion on the concept of international jurisdiction of the legal system in general, see LOUIS HENKIN ET AL., INTERNATIONAL LAW 820 et seq. (1987). For discussion on application of taxation, see *id.* at 258 et seq. In Canada, there is territorial and personal jurisdiction on the basis of residence. *See, e.g.*, VERA KRISHNA, THE FOUNDATIONS OF CANADIAN INCOME TAX 79 (3rd ed. 1989). There are States which have adopted tax jurisdiction mainly based on the territorial element. *See, e.g.*, J.M. Elegido, *Income Taxation in Nigeria*, 1990 BRIT. TAX REV. 36, 50–51.

Despite the similarity between international law, in general, and in the area of taxation, there are nevertheless differences between the two. Thus, for example, it is accepted that States do not assist each other to enforce tax obligations to other States. *See, e.g.*, Government of India v. Taylor, 1955 App. Cas. 491 (appeal taken from Eng.); Williams & Humbert Ltd. v. W & H Trade Marks (Jersey) Ltd., 1986 App. Cas. 368 (appeal taken from Eng.).

7. *See* Cook v. Tait, 265 U.S. 47 (1924). *See also*, ISENBERGH, *supra* note 3, at 29.

laws of a particular State for it to be liable to be taxed by that State, as provided by U.S. income tax law from its inception,[8] and by English law since the late 1980's,[9] or should the traditional English law prevail,[10] whereby a corporation will be regarded as residing in the country in which its "central management and control" is located?

The phenomenon of double taxation, and at times of treble, quadruple, or greater, taxation, occurs when international jurisdictions of different States' income tax regimes coincide so that several States claim tax on the same income. There are three basic models of conflicts between concurrent jurisdictions of different States: conflict between personal jursidictions, conflict between territorial jurisdictions, and conflict between personal and territorial jurisdictions.

1. Conflict Between Personal Jurisdictions

Conflict between personal jurisdictions occurs where a particular taxpayer has personal links which create a liability for tax imposed by two or more States. For example, a taxpayer who is a citizen of State A with jurisdiction based on citizenship may, at the same time, be a resident of State B where jurisdiction is based on residence, and be domiciled in State C where personal jurisdiction is linked to domicile. In such circumstances, all three States will claim jurisdiction to tax the same income. Such a conflict may also arise between States that have adopted the same personal link if the taxpayer fulfills that link for each State. For example, if the link of citizenship has been adopted by all the States involved in a particular tax event, a taxpayer with the citizenship of several States will be liable for tax in all those States. This conflict would also occur between States that have adopted the criterion of residence as the basis for personal jurisdiction, but where each State defines residence in a different way, so that the taxpayer is a resident of all the States at the same time.

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8. I.R.C. § 7701(a)(4), (a)(5) (1988); MUSGRAVE & MUSGRAVE, *supra* note 1, 761–62; KAPLAN, *supra* note 6, at 7.

9. Denis Sheriden, *The Residence of Companies for Taxation Purposes*, 1990 BRIT. TAX REV. 7. A similar position is taken by Dutch law. *See* Corporate Income Tax Act § 2 (1969) (Neth.). Under Dutch tax law a corporation will be subject to Dutch income tax if it is resident in the Netherlands. Residence is determined by whether the place of incorporation is in the Netherlands or whether the central management and control are in the Netherlands. *See* GERRIT TE SPENKE & PETER LIER, TAXATION IN THE NETHERLANDS 59 (1992).

10. *See, e.g.*, Stephen W. Mayson, *Corporate Control in* RECENT TAX PROBLEMS 29 (Jacqueline Dayson ed., 1985); PINSON, REVENUE LAW 184–85 (17th ed., 1986); WHITEHOUSE & STUART-BUTTLE, REVENUE LAW 506 (1990); RICHARD BRAMWELL ET AL., TAXATION OF COMPANIES AND COMPANY RECONSTRUCTIONS 273–75 (1985).

2. Conflict Between Territorial Jurisdictions

Conflict between territorial jurisdictions will occur where each territorial jurisdiction has a different source rule determining the geographical source of income, so that a number of territorial jurisdictions demand tax for the same event.

3. Conflict Between Territorial and Personal Jurisdictions

Conflict between territorial and personal jurisdictions is the most frequent conflict, occurring where certain income was incurred in one State (hereinafter referred to as the State of origin or source) by a taxpayer who maintains personal ties with another State which create a tax liability in that State (hereinafter referred to as the State of residence or citizenship[11]). Such a conflict is regulated by conventions for preventing double taxation, and also by unilateral provisions in various income tax systems intended to modify the tax burden resulting from such a conflict. References in the present article to double taxation resulting from the concurrent jurisdiction of tax regimes of several States are to the conflict between the State of source and the State of residence.[12]

As already mentioned, four main factors determine the scope of any particular jurisdiction: economic efficiency, equity,[13] economic growth, and the influence of statist-political thinking. I shall now consider each of these factors in turn, considering the first three factors in brief, and discussing the fourth factor at greater length, focusing on the case of Israel.

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11. Because most countries base the personal link on residence or citizenship, not on domicile, the article uses the term "the State of residence or citizenship."

12. The three categories put forward are the basic ones, because a combination among them may create further categories, like a conflict between two personal jurisdictions and territorial jurisdiction. For example, a U.S. citizen who is a resident of the United Kingdom and who earns income in France. Such a set of circumstances is within the reach of the tax laws of the United States and the United Kingdom on the basis of personal jurisdiction (citizenship and residence together), as well as the tax laws of France on the basis of territorial jurisdiction.

The various jurisdictions produce not only double taxation, but may also, under certain conditions, bring about exemption from tax, because the taxpayer may not fall within their scope. Naturally, such possibilities are limited, so the article has not referred to them.

13. Until World War I, conflict between tax jurisdictions was examined in accordance with equity considerations, but subsequently attention was turned to economic aspects, particularly efficiency. *See* PEGGY BREWER RICHMAN, TAXATION OF FOREIGN INVESTMENT INCOME — AN ECONOMIC ANALYSIS 1 (1963).

B. *Considerations of Efficiency*

There are three main considerations of economic efficiency which determine international tax jurisdiction: (1) capital export neutrality; (2) national neutrality; and (3) capital import neutrality.

1. Capital Export Neutrality

Capital export neutrality suggests that the international tax regime bringing about the most efficient allocation of resources should be adopted,[14] so that the yield to the investor after deduction of tax will not be dependent on the place where the income is produced. Thus, investors will invest in the place producing the highest yield. The tax regime ought not to bring about a change in the forms of investment, so that the tax factor should not affect the investor's decision. This criterion of neutrality will be realized if the following two conditions are met. First, the State of residence must adopt a personal rule of jurisdiction whereby its residents will be taxed on a worldwide basis, independently of the place where income is produced. Second, the State of residence must grant a tax credit for foreign tax paid to the State of source by its resident. Such credit should result in the same yield after tax for income produced abroad as for income produced within the territory of the State of residence.[15] Such neutrality brings about an efficient allocation of resources on a worldwide basis, or, in other words, it amounts to international tax neutrality. This neutrality maximizes universal welfare, but not necessarily the welfare of the State of residence.[16] Because we are

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14. As to this neutrality, see, e.g., MUSGRAVE & MUSGRAVE, *supra* note 1, at 761.

15. Because the State of residence does not refund to the taxpayer the tax he paid to a foreign State, this statement is correct only on the following alternative assumptions: Either the tax paid to the State of origin is not higher than that imposed by the State of residence or the tax in the State of origin is higher, but the taxpayer can receive as credit the difference in various ways, such as by using it against other income from the same State of origin or by adding it to foreign tax paid to another State of origin in respect of income accruing there. *See also id.* at 761–62. For foreign tax credit under the IRC, see, e.g., KAPLAN, *supra* note 6, at 81; ISENBERGH, *supra* note 3, at 471. For English law, see Income and Corporations Taxes Act, 1988, pt. XVIII, ch. 2, §§ 792–806 (Eng.); Comm'r of Inland Revenue v. Hang Seng Bank Ltd, [1991] 1 App. Cas. 306 (P.C. 1990) (appeal taken from Hong Kong); Yates v. GCA International Ltd, 1991 S.T.C. 157 (Ch.), *available in* LEXIS, UKTAX Library, CASES file.

16. For a discussion on the different aspects of efficiency, see, e.g., Peter Gumpel, *The Taxation of American Business Abroad—Is Further Reform Needed*, 15 J. INT'L L. & ECON. 389 (1981); David G. Hartman, *The Effects of Taxing Foreign Investment Income*, 13 J. PUB. ECON. 213 (1980); PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENTS (1969); Musgrave & Musgrave, *supra* note 1, at 761. There are additional considerations of efficiency, such as costs of enforcement and collection, but these are relatively unimportant compared with those discussed here.

dealing with the scope of international jurisdiction and how far it extends beyond territorial frontiers, and not with the scope of the tax burden or techniques for avoiding double taxation, it follows that for our present purposes, emphasis should be placed on the first condition referred to above in support of personal jurisdiction.

2. National Neutrality

Under the national neutrality criterion, all income should be divided in the same proportion between the tax authority of the State of residence and the taxpayers.[17] For this, two conditions are required. First, the tax regime of the State of residence must be applied to income produced abroad, that is, personal jurisdiction must be determined. Second, the taxpayer will not be *credited* for the foreign tax that he paid in the State of source, but instead the tax will be *deducted* in calculating tax liability in the State of residence. Efficiency is thus tested by comparing the yield *after foreign* tax with the yield *before domestic* tax. This system is most efficient from the point of view of the State exporting the capital — the State of residence. Taxpayers of the State of residence will invest abroad up to the point where the yield after foreign tax (the tax imposed by the State of source) is identical to the yield before tax imposed by the State of residence. The State of residence thereby maximizes its national product since the share of the foreign tax, as opposed to its own tax, is not a part of the national product of the State of residence. This approach also demonstrates that an essential condition is the creation of international jurisdiction on a personal basis. Otherwise income produced abroad will not be taxed, and national neutrality will not exist.[18]

3. Capital Import Neutrality

Capital import neutrality requires the creation of neutrality between sources of income within a territory in such a way as to allow for efficient allocation of those sources within the territory. This means adopting an exclusively territorial jurisdiction, a project which has two aspects. First, the State of residence must grant tax exemptions for income that their residents have produced abroad, thereby bringing about efficiency in allocation of resources within the State of source because

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17. For this criterion, see Gumpel, *supra* note 16, at 396–97; MUSGRAVE & MUSGRAVE, *supra* note 1.

18. For the contrast within the statist-political philosophy between global and national considerations, see, e.g., Robert Gilpin, *Three Models of the Future*, 29 INT'L ORG. 37 (1975).

there will be no difference between the yield after tax from local investments and the tax from foreign investments. The second aspect focuses on taxation by the State of source: All income produced within the territory of that State must be made liable to tax therein, even if it is derived from foreign investments. It should be pointed out that while capital export neutrality brings about efficient allocation of resources from a universal perspective, national neutrality increases the national product in a most efficient manner. Capital import neutrality, on the other hand, increases the efficiency of allocation of capital resources only within the territory, without distinguishing the "national origin" of these resources.[19] Universal efficiency is not achieved in this instance, since economic activity will be transferred to tax regimes where the tax burden is lowest. Nor will national neutrality be achieved in such a case, since territorial jurisdiction brings about a reduction in national income produced abroad to the level of the foreign tax paid.[20]

C. *Considerations of Equity*

The principles of social justice regarding the distribution of the tax burden within a society include those of "horizontal" and "vertical" equity. Horizontal equity requires that taxpayers with the same income should have the same tax burden. Vertical equity requires that taxpayers with differing incomes should divide the tax burden among themselves in a fair manner. In various States, different social attitudes providing different answers to the question of what is a fair division of the tax burden under the principles of vertical equity prevail. If the principle of ability to pay is accepted, then horizontal or vertical equity has to be examined according to the economic ability of the taxpayer. This transcends frontiers in that if a person has produced income abroad, this must also be taken into account for purposes of applying horizontal or vertical equity. Imposition of tax in accordance with economic ability necessitates ignoring the place where income is produced, and favors the acceptance of a form of personal jurisdiction which is as wide as

19. In other words, the personal aspect of the taxpayer must be ignored.

20. One view is that capital import neutrality requires that capital exporting countries subsidize residents who invest abroad at the same rate that other countries subsidize their capital export, thus increasing capital import neutrality. This view raises a number of difficulties. For example, every capital exporting country has to know exactly the rate of subsidy which other countries grant in respect of capital exported by them. Moreover, comparison of subsidies may cause certain States to dictate to others the extent to which they should subsidize capital export. For discussion of this topic, see, e.g., Stanley S. Surrey, *Current Issues in the Taxation of Foreign Corporate Investment*, 56 COLUM. L. REV. 815, 849 (1956). For criticism of the three views of efficiency mentioned, see Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. ECON. 793 (1980).

possible to measure the overall economic ability of the taxpayer more fairly. Even if the personal approach is adopted, there are two alternative ways of putting it into practice: First, by means of a foreign tax *credit*, creating international equity, and second by means of a foreign tax *deduction*, creating a national equity. These two types of equity are two different ways of achieving "interindividual" equity.[21]

This topic may also be regarded from the point of view of interstate equity, whereby the distribution of tax revenue between the two States concerned is determined. For example, the rate at which the State of source taxes income is of considerable importance in the distribution of tax revenue between that State and the State of residence.[22] In this context, the foreign tax credit is a manifestation of interstate equity only from the point of view of the State of source which taxes foreigners to the same extent as it taxes local residents. From the point of view of the State of residence such credit offends interstate equity, and is inferior to the technique of deduction which leaves larger resources in the State of residence than does the technique of credit.

How are these principles applied to a tax regime based on territorial jurisdiction? Should the ability to pay be examined solely according to income produced in the country of source? A positive reply to the latter question would offend social justice because under the principle of ability to pay, attention cannot be confined to local income, but must consider all the taxpayer's income, irrespective of where it was produced. However, with territorial jurisdiction, the State of source taxes only income produced within its territory, and so these principles should be applied only to such income. This discrepancy follows from the fact that taxation on the basis of territorial jurisdiction takes into account a certain segment of a person's income, so that the principle of ability to pay is not put into effect.[23] Naturally, application of the principles of equity to international taxation is a highly involved process, which requires separate treatment. Examples of questions which arise in this context are: Should foreign residents also be allowed a progressive tax structure under territorial jurisdiction? What is the position with regard to personal deductions? How should one treat foreign tax where taxation under personal jurisdiction is concerned?[24] These and other aspects of

21. *See, e.g.*, MUSGRAVE & MUSGRAVE, *supra* note 1, at 760.

22. There exists an additional approach, the one referred to as reciprocity, whereby the State of source should tax foreign residents at the same rate at which other States tax its residents. *See, e.g.*, *id.* at 761.

23. *See infra* part II.E.

24. *See, e.g.*, RICHARD GOODE, GOVERNMENT FINANCE IN DEVELOPING COUNTRIES 77 (1984).

equity have a close link with the effect of statist thinking as explained in Part II.E. For our present purposes, from the point of view of equity, personal jurisdiction is preferable to territorial jurisdiction.

D. *Economic Growth*

Resort to the rules of international jurisdiction in an income taxation regime to promote economic growth generally involves two basic components. The first and most common is related to territorial jurisdiction of the tax regime with regard to taxation of yield from foreign investments. An outstanding example is evident in developing countries, and sometimes also in lesser developed countries (LDC), in which the prevailing economic policy is to encourage economic growth by attracting foreign investment through various incentives, mainly generous tax reliefs and exemptions, on yield from such investment.[25]

The second component, which is comparatively rare, affects the rules of personal international jurisdiction by providing that tax relief, including exemption from tax, will be granted with respect to certain activities abroad.[26]

A tax policy which emphasizes economic growth may prejudice economic efficiency. Such a policy is diametrically opposed to capital import neutrality. It likewise prejudices the principle of capital export neutrality, since foreign investors will prefer, for tax reasons, those States that provide incentives. Thus, it will bring about an inefficient global allocation of resources. On the other hand, it does not prejudice

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25. *See, e.g.*, MUSGRAVE & MUSGRAVE, *supra* note 1, at 800–01.

26. Developed countries may utilize the tax system so as to encourage economic activity abroad. This approach was adopted by the U.S. tax regime which imposed a reduced rate of tax on U.S. exporters by means of the special tax regime known as the domestic international sales corporation (DISC) which was in effect from 1971 to 1984, and which was partially replaced by the foreign sales corporation (FSC) regime, owing to infringements of the General Agreement on Tariffs and Trade. *See* IRC §§ 921–27 (1988); JOSEPH A. PECHMAN, FEDERAL TAX POLICY 171–72 (5th ed. 1987).

As to this tax regime, which forms an exception to the normative structure of tax law and amounts to tax expenditure, see STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 160 (1985). *See also* STANLEY S. SURREY, PATHWAYS TO TAX REFORM 186 (1973).

Israel grants a certain tax relief to foreign residents who invest in certain activities. For a concise description of this tax regime, see David Gliksberg, *The Taxation of Corporations and Shareholders in Israel: The Necessity for a Comprehensive Tax Reform*, 5 FLA. INT'L L.J. 327, 345 (1990).

There is a connection between the rules of international jursidiction of the income tax regime and the model of taxing the corporation and its shareholders (the topic of double taxation and integration between taxation at the level of the corporation and at the shareholder level). *See, e.g.*, MARTIN NORR, THE TAXATION OF CORPORATIONS AND SHAREHOLDERS 152–92 (1982). *See generally* Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719 (1981).

the principle of national neutrality, since it requires that all income should be distributed in the same proportion between the tax authorities of the State of residence and the residents of that State, by placing the tax system on a personal basis.

Considerations of economic growth may also prejudice the rules of equity. Economic growth does not necessarily lead to a fair distribution of the economic wealth achieved by such growth; there is a distinction between enlarging the "pie" and the way the "pie" is divided. Arguably, a policy of economic growth which prejudices the rules of equity can only be adopted as a short-term policy, or sometimes for a medium term. It would be difficult, however, to adopt such a policy for the long term, in view of its social effects. On the other hand, a policy of economic growth which prejudices considerations of universal efficiency but conforms to those of national efficiency, can be adopted even in the long term, from the point of view of the State concerned.

Those who devise the international income taxation regime are thus caught in a classic dilemma: How should a proper balance be struck between considerations of economic growth and those of efficiency and equity? From that point of view, the international component of the income taxation regime is no different from other components of the tax regime, characterized by the same discrepancy, sometimes accomplished with greater force.[27]

E. *Aspects of the Statist-Political Approach*

The scope of the international jurisdiction of the income taxation regime is derived also from the statist-political conception of the State in which the tax regime in question operates. An analysis of the jurisdictional aspects of the tax regime in any particular State must refer to such considerations. Two States may adopt different international jurisdictions in their tax regimes, even though they have the same outlook with respect to fiscal policy considerations of efficiency, equity, and economic growth, because of their differing statist-political conceptions.

The political justification for territorial jurisdiction is derived from the basic function that the tax institution is intended to fulfill: Financing government expenses.[28] Foreign taxpayers who produce income within the bounds of a particular territory are obligated to participate in various governmental costs related to the creation of environmental conditions (e.g., infrastructure, communications, skilled manpower, and environmental

27. *See, e.g.*, WEBBER & WILDAVSKY, *supra* note 2, at 522.

28. *See, e.g.*, GOODE, *supra* note 24, at 78.

standards in the workplace) which affect the extent of income derived from that territory. It follows that foreign residents must also bear the cost of public expenditure, by means of the tax system. Justification for imposing such taxes is centered on the connection between income and governmental expenditure incurred in creating a working environment to enable the production of that income. As mentioned above,[29] this determination is only the first stage of the structure, upon which the second has to be laid: that is, whether the taxpayer, liable for tax solely by virtue of territorial jurisdiction, should be saddled with the same effective tax burden as the local resident. The answer to this question is complex in several respects. First, it can be examined in accordance with the various functions of the tax system such as financing government expenditure, attaining social aims like redistribution of income, and the attainment of economic goals.[30] If the question is examined from the point of view of financing government expenditure, then it can be argued that a foreign resident ought to incur a smaller share of government expenditure, since a foreigner enjoys a more limited range of services than a local resident. This way of presenting the principle of social justice rests on the benefit principle, but can also be formulated in terms of the ability to pay principle, despite the essential difficulty inherent in the fact that the State of source has to measure the economic ability of a taxpayer in the State of residence. Moreover, a comparison may reveal differences between economic ability in the State of source and that of residence owing to differing economic, social and political conditions in the two States.

If the question of equity is examined with a view to the object of achieving social goals, it then becomes more complex, since the objects of social policy are, as a rule, local residents or citizens. Thus, for example, should the provisions aimed at a redistribution of income be applied to foreign residents? In other words, is a foreign resident part of that "society" the income of which we are seeking to redistribute? This also applies with regard to economic objectives, some of which may require for their achievement by means of the tax system that they be applied to foreign residents. An example of this is the encouragement of

29. *See supra* INTRODUCTION.

30. The article refers here to the existing, positive objects, not the normative ones. As to income tax regimes in the world, from the normative point of view, there is sharp public controversy as to whether the tax system should be used to achieve economic and social goals. *See, e.g.*, SURREY, *supra* note 26; *Tax Incentives as an Instrument for Achievement of Governmental Goals*, (1976); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy — a Comparison with Direct Goverment Expenditures*, 83 HARV. L. REV. 712 (1970).

On the statist-political approach and the question of redistribution, see, e.g., ANTHONY DE JASAY, THE STATE 187–249 (1985).

a particular economic activity by means of reduced rates of tax. There may, however, be other economic objects intended to encourage the economic activity of local residents which disregard foreign residents.

Territorial jurisdiction ignores the income of residents or citizens of a State which is produced abroad. It thus adopts the statist approach whereby the essence of a State is enshrined in its territory, so that the State has the political right to tax only income produced within its territory, but irrespective of the identity of the person producing such income.[31]

In contrast to territorial jurisdiction, personal jurisdiction imposes tax on all income, irrespective of where it was produced, of everyone having the personal link underlying that jurisdiction. This jurisdiction is based on a statist conception that the State has the right to tax its citizens and/or its residents, because the center of the "State" is not its territory but its population, i.e., its residents or citizens. It follows that the State has a legitimate right to tax its residents on their earnings from every source. The focus on the person, rather than on territory, means that a taxpayer who complies with the personal link becomes liable for tax imposed by the State of residence, even though he or she did not produce the income there, because he or she is bound to participate in financing that government's expenditure. Such participation is derived from the fact that residence implies that the taxpayer belongs to a particular society and that he must therefore share in the expenses of that society. Personal jurisdiction does not focus on the connection between the foreign income and the government expenditure which made its production possible, but rather on the connection between the resident and the State, and the taxpayer's general duty to contribute to government expenditure since he or she benefits from the full range of its services, in all spheres of life, not just in the context of creating the conditions for producing the specific income which is taxed. The use to which the income is put is relevant here in order to base the tax system on principles of equity — in particular the principle of ability to pay — which examines the income of the taxpayer from every source, including that produced abroad. Even from the point of view of the other objects of the tax system such as the promotion of social and economic aims, the personal approach has much logic to commend it. For example, it is substantially right that redistribution of income within society should apply to all the income of the members of that society, because they, and not foreign residents, are the object of the redistribution.[32] With regard to attainment of economic goals, every

31. *See* dicta of Lord Wrenbury, in Whitney v. I.R.C., [1926] App. Cas. 37 (appeal taken from Eng.).

32. *See, e.g.*, GOODE, *supra* note 24, at 78; *see also* YOSEPH M. EDREY, TAXATION OF

arrangement must be investigated separately in the light of the economic goal it seeks to realize.

From a political point of view, a State that has opted for personal jurisdiction is not prevented from adopting territorial jurisdiction as well. The political viewpoint that favors personal jurisdiction does not negate territorial jurisdiction as far as taxation of the income of foreign residents is concerned, because there is no justification for a foreign resident's lack of participation in financing the government expenditures which enabled him to produce the income. Indeed, as a rule, States that have opted for personal jurisdiction have also adopted territorial jurisdiction.[33] A tax regime adopting personal jurisdiction together with partial territorial jurisdiction, or without any territorial jurisdiction, is a possibility. However, this would not be a normative tax regime, but an incentive-based regime,[34] designed to grant tax concessions to foreign residents. On the other hand, tax regimes may possibly be based solely on territorial jurisdiction, backed by the political theory that it is not right for a State to tax its residents on their earnings produced abroad. Thus, for example, the former English view, which served as an example for many tax systems throughout the world, was that the tax system should be based on territorial jurisdiction alone.[35] The changeover in those tax systems from a regime based on territorial jurisdiction to one based on personal jurisdiction should not be attributed solely to considerations of efficiency or of social equity following the expansion of international trade. Rather, this changeover should be attributed also to changes in political and statist outlook as it reflects the transfer of the center of gravity in political thinking from the territorial to the human element; in other words, to the members of the community subject to the social order of the State in question (its residents or citizens).

Whenever the object of the tax system, or of sovereignty, is examined, we are faced with two focal points. The first is territorial, since territory is an essential condition for the political framework to function. The second focus is on the persons who are the object of that political framework, because the ultimate consumer of that framework is the individual belonging thereto. This second focus attaches a more instrumental significance to the territorial focus, regarding it as intended to serve

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INTERNATIONAL ACTIVITY 36 *et seq.* (A. Yoran ed., 1992).

33. For example, that is the law in the United States, United Kingdom, and Canada.

34. For the distinction between a normative tax regime and one based on incentives, see, e.g., sources cited *supra* note 30.

35. Today, the British income tax jurisdiction is a broad personal one.

the human focus.[36] Professor Akzin expresses this well in the following words:

> We have noticed that the territory of a State, in its widest sense, forms the ecological setting which is vital to the state even on the theoretical level, whereas in the narrow sense territory implies a considerable degree of permanence and preciseness and is thus essential to the modern state, at least on the practical level. On the other hand, population is an even more prominent feature of the state. We have defined the state as a particular form of human organization, imposing its rule over people; thus human beings feature as an essential condition from all points of view for the existence of the state, both as subjects and objects of the organization and of the governmental functions therein. If we regard the state as a legal abstraction, as a system of norms complete within itself, then those norms are directed towards people, without which we should have a vacuum. We can regard the state as a manifestation of power in the context of society, the power being that of society, exercised by people and towards people, so that without people we have a mere void. If we regard the state as a historical phenomenon, then, again, we are dealing with the history of human society, in which human beings are the beginning and the end.[37]

In the past, the classical concept was marked by preference for the territorial, rather than the personal, viewpoint. However, there were countries, notably the United States, that attributed overwhelming importance to the personal aspect. In the United States, the personal link of citizenship was regarded as a solid foundation for tax liability, based on the political outlook which attached great importance to the concept of citizenship as a fundamental component of the State.[38] The most prominent

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36. For a contrast between the territorial and the personal or communal, see, e.g., HANS KELSEN, GENERAL THEORY OF LAW AND STATE 207–18 (1949). *See also* Rolando Salmorán, *The State as a Problem of Jurisprudence*, *in* THE STUDY OF THE STATE 387 (Henri Chessen & Peter Skalnik eds., 1981).

37. *See also* BINYAMIN AKZIN, THEORY OF GOVERNMENT 64 (1963) (translated from Hebrew by author). The erosion of the territorial aspect is also reflected in the increasing popularity of the functional approach, centering on the functions that the State fulfills. For this approach, see, e.g., ROMANO ROMANI, THE INTERNATIONAL POLITICAL SYSTEM 23 (1972).

For the classical statist approach (nonfunctional) which focuses on the elements of the State: people, territory, government and sovereignty, see, e.g., JOSEPH FRANKEL, INTERNATIONAL RELATIONS IN A CHANGING WORLD 16–17 (1979).

Even according to this classical approach there is an interplay between the various statist components such as people and territory, which reflects, *inter alia*, the interplay between territorial and personal jurisdictions.

38. *See, e.g.*, George A. Kelly, *Who Needs a Theory of Citizenship?*, *in* THE STATE 21 (Stephen R. Granbard ed., 1979).

expression of this is in the judgment of the Supreme Court of the United States in *Cook v. Tait* where the Court stated:

> In other words, the principle was declared that the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete. Or to express it another way, the basis of the power to tax was not and cannot be made dependent upon the status of the property in all cases, it being in or out of the United States, and is not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relationship as a citizen to the United States and the relationship of the latter to him as a citizen.[39]

A close examination of this decision does not make it clear why the Court regarded citizenship as the proper link for imposing tax liability. The decision is the outcome of U.S. political philosophy which attributes overwhelming significance to nationality. The exact balance between the various factors — efficiency, equity, and economic growth — which defines the international bounds of the income taxation regime is likely to be determined, consciously or otherwise, by the political outlook of the State. Attaching decisive importance to capital import neutrality may be the result, *inter alia*, of a political outlook which puts stress on the territorial focus of the statist-political philosophy. On the other hand, putting the stress on capital export neutrality is more consistent with the personal focus of the statist-political philosophy.

II. The Israeli International Income Tax Regime

A. *In General*

Israeli income tax law covers two types of jurisdiction: Extensive territorial jurisdiction based on the geographical location of the source from which the income was produced, and personal jurisdiction based, generally speaking, on residence. Historically,[40] the Israeli tax regime covered only territorial jurisdiction, but personal jurisdiction was added later.[41] Personal jurisdiction is only partial, in the sense that an Israeli resident is liable for Israeli taxation only on a very limited segment of income produced abroad.

39. Cook v. Tait, 265 U.S. 47 (1924).

40. *See, e.g.*, S. Moses, The Income Tax Ordinance of Palestine 49 (2d ed. 1946).

41. By extension of The Income Tax Ordinance (New Version) § 5 (1961) (Isr.).

B. *Territorial Jurisdiction*

Territorial jurisdiction in Israel has two basic, alternative links: That of production of income, and that of receipt of income. The former decrees that income produced in Israel is liable to Israeli tax, irrespective of the residence of the person producing the income. The courts have held that for every type of income there exists an appropriate source rule, and that capital gains have different source rules from those of ordinary income.[42] The layer of territorial jurisdiction in the Israeli tax regime, as far as the production link is concerned, is not unique. It is similar in its principles and its provisions to territorial jurisdiction of the classical tax regimes in Western countries.[43]

The remittance factor provides that income received in Israel is liable to Israeli tax even if it is not produced in Israel. This type of territorial jurisdiction is most imperfect, and the law provides that foreign residents are exempt from tax on such income,[44] so that the question of liability to tax by virtue of this connection only arises with respect to Israeli residents. It is indeed only of marginal importance, given the very narrow application of the provision by the courts, which have held that the requirement of receipt is not met if the income was received abroad in the first place, and only subsequently, even immediately afterwards, remitted to Israel.[45] Even though the currency control regulations require Israeli residents to remit their income to Israel, there is nothing legally or practically, to prevent their leaving such income at an "intermediate station", to avoid taxation on the basis of the remittance connection.

C. *Personal Jurisdiction*

1. In General

In addition to territorial jurisdiction, Israeli law provides for personal jurisdiction based on the connection of residence, whereby certain income

42. *See id.* § 89(b)(2); David Gliksberg, *The Remittance Jurisdiction and the International Jurisdiction of Capital Gains Taxation*, 5 TAXES A-29 (1991).

43. Except for special arrangements granting tax relief to foreign investors in certain activities. *See* Encouragement of Capital Investments Law 13 Laws of the State of Israel [Laws St. Isr.] 258–76 (1959); Gliksberg, *supra* note 26.

44. Income Tax Ordinance § 29.

45. Bronfman v. Assessing Officer Netania, 20 Income Tax Cases 41 (1992) (Isr.) (in Hebrew). The jurisdiction of remittance exists in England, but it varies in extent, according to the nature of the income. *See, e.g.*, INCOME AND CORPORATION TAXES ACT, *supra* note 15, §§ 65(5)(a), 132(5); CAPITAL GAINS TAX ACT § 14(2) (1979)(U.K.). *See also* Harmel v. Wright, [1974] 1 W.L.R. 325 (Ch.).

not produced in Israel will be taxed in Israel if it is produced by an "Israeli resident." The scope of personal jurisdiction is thus derived from two variables: First, who is an Israeli resident? and second, what income is covered by personal jurisdiction?

2. Who is an "Israeli Resident?"

The definition of "Israeli resident" distinguishes between individuals and corporations.[46] An individual is a resident if he or she resides in Israel, and is not absent therefrom except for temporary absences which are, in the opinion of the assessing officer, reasonable and not inconsistent with the claim of that individual to be a resident of Israel.

A corporation is defined in section (1) of the Israeli income tax ordinance as "resident in Israel" by means of a twofold, alternative definition, as follows:

> (1) A corporate body registered in Israel whose main activity takes place in Israel; provided that if it is registered as a foreign company it shall only be regarded as a resident of Israel if it so requests; if it has so requested it shall not be allowed to retract before the expiry of three tax years unless the Minister of Finance permits otherwise.
>
> (2) A corporate body the control of whose dealings and their management are performed in Israel.

With regard to individuals, the law has adopted the test of "reasonable temporary absence," whereby a person who is away for reasonable periods is still a resident of Israel. The law does not determine what is a reasonable temporary absence. That question is left to the courts.[47] Moreover, the definition appears to deal with circumstances in which the taxpayer seeks to be regarded as an Israeli resident. This is evident in the last part of the definition which states that the temporary absence should be reasonable and not inconsistent with the taxpayer's claim to be an Israeli resident.

There is also a lack of clarity in the definition of residence of a corporation. In the first alternative of the definition of residence (hereinafter referred to as the test of the principal activity and place of registration), the law does not indicate how to determine what is the "principal"

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46. Income Tax Ordinance § 1.

47. This result is consistent with the general trend of the international income taxation regime in Israel, whereby important topics have not been regulated by statute, the legislator expecting that the issues will be settled by the courts. Thus, for example, the statute hardly deals at all with source rules, a central theme in territorial jurisdiction, leaving this task to the courts.

activity of the corporation. A substantive test may be adopted to determine where the main activity takes place, in which case "substantive" may take on a different meaning. The second alternative (hereinafter referred to as the test of control and management) is also not sufficiently clear. Of what do control and management consist? Are these two separate concepts, or is it a single concept identical to the English notion of "central management and control?" This obscurity of interpretation has not yet been clarified by the courts.[48]

3. What Income is Liable to Tax by Virtue of Personal Jurisdiction?

Personal jurisdiction in Israel covers a very small segment of income, and in practice there is a dispute over the question of its full extent. There is, however, no argument that the following two categories of income are within its scope:

a) Income from the occupation of an Israeli resident in which he normally engages in Israel.[49] For this purpose there is no relevance as to whether he is employed in Israel or abroad, as an employee or self-employed.

b) Income from employment of Israeli residents employed abroad by Israeli residents, within four years from the time the resident leaves Israel, or within a longer period where the employer is an Israeli governmental or quasi-governmental entity.[50]

There is a third category of income about which there exists a difference of opinion as to whether it should be covered by personal or by territorial jurisdiction. The law provides that profits or earnings which

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48. Apart from personal international jurisdiction on the basis of residence, there is also international jursidiction based on citizenship in respect of the activity of Israeli citizens in the territories occupied by Israel since 1967. Under Israeli law, those territories are foreign territory like any other foreign State, so that the rules of international jurisdiction of income taxation in Israel apply to them, unless there is a statutory provision to the contrary. Statutory provision is made for taxation based, *inter alia*, on personal jurisdiction on the basis of citizenship, whereby Israeli citizens are liable to replace statutory criterion of residence by that of citizenship, in view of the fact that Israeli citizens living in the occupied territories are not within the definition of Israeli residents, but are residents of those territories. *See* Income Tax Ordinance § 3A.

49. *Id.* § 5(1). For the criteria as to when there is identity of occupations, see Bronfman, *supra* note 45; Ahitov v. Assessing Officer Gush Dan, 16 Income Tax Cases 238 (1988) (Isr.) (in Hebrew).

50. Income Tax Ordinance § 5(3). The combination of sections 5(1) and 5(3) of the Ordinance creates several material difficulties. *See* David Gliksberg, *Taxation of Income from Employment Earned Outside Israel*, 5 TAXES, A-46 (1991).

a person derives from a business the control and management of which are exercised in Israel is liable for Israeli income tax even though the activity is performed abroad.[51] A possible view (hereinafter referred to as the narrow view) is that this provision should be classified as a source rule (under the test of the place of source) and should therefore be regarded as an integral part of the complex of source rules which make up territorial jurisdiction. On the other hand, a different approach (hereinafter referred to as the wide view) regards this provision as belonging to the rules of personal jurisdiction, because it provides that anyone exercising control and management in Israel has the personal connection for purposes of tax obligation. Such a provision relates to the second alternative in the definition of "Israeli resident,"[52] whereby a corporation, the control and management of which is exercised in Israel, is to be classified as an "Israeli resident." According to this view, corporations which are resident in Israel by the control and management test will be made liable to tax on income from their business on a worldwide basis.

The common ground between the two approaches may be found in the area of foreign tax credit. As a rule, Israel has unilaterally adopted, where there is no double tax convention applicable, an arrangement[53] which allows for a credit for a foreign tax. Such credit is granted by the State of residence on tax paid to the State of source. In other words, when there is a conflict between the State of source and that of residence, the former imposes primary liability on the income, while the latter also imposes liability but grants a credit with respect to foreign tax. The mechanism of foreign tax credit is not generally the appropriate one for modifying the effect of double taxation where there is a conflict between territorial jurisdictions or between personal jurisdictions. In both these situations, there is no rule granting preference to one jurisdiction over another since both jurisdictions have the same nature — territorial or personal.

Let us illustrate this common ground by taking the case of an Israeli corporation which earns income abroad liable to be taxed by the State of source and liable to Israeli tax because its control and management are exercised in Israel. Is the taxpayer entitled, in calculating Israeli tax liability, to a credit for the foreign tax he has paid? The answer to this question depends on which of the two views presented above is adopted. According to the narrow view, which regards the control and management test as a source rule, the taxpayer will not be entitled to a credit for the foreign tax because the conflict is between territorial jurisdictions, and in such a conflict the mechanism of credit for foreign tax does not apply. On

51. *See* Income Tax Ordinance § 5(1).

52. *See supra* note 46 and accompanying text.

53. *See* Income Tax (Double Taxation Relief) Order (1963) (Isr.).

the other hand, if the control and management test serves as the personal identity test, the taxpayer ought to be granted a credit for foreign tax since we are here faced with the classical conflict between personal and territorial jurisdictions. This article takes the position that the control and management test is territorial in nature, for three main reasons.

First, there is no reason why a taxpayer classified as an "Israeli resident" by the test of principal activity and place of registration should not be liable to tax on his income from a business on a worldwide basis. This conclusion emerges from the view that the control and management test creates personal jurisdiction.

Second, classification of the control and management test as a personal test raises the question why a taxpayer fulfilling this test should not be liable for tax on *all* his income on a worldwide basis and not only on his income from business. Restricting the liability to tax only to income from a business makes it quite clear that the control and management test is intended to determine the place of source of income from a business when the activity of the business extends over a number of countries.[54]

Third, the control and management test not only applies to corporations, but also to every taxpayer, including an individual or a partnership, that earns income from a business, the control and management of which are exercised in Israel. Thus, control and management are not intended to characterize the residence of the taxpayer, because the residence of an individual is not in any way dependent on those factors, but rather to indicate the source rule of income from a business.

III. The Effect of the Israeli Statist-Political Approach on the International Income Tax Regime

From this description of the international income tax regime of Israel, the influence of the territorial statist-political philosophy of Israel is clear. This political outlook, derived from a wider political conception regarding regional disputes, accords considerable importance to the territorial aspect of the statist entity. This conception focuses on the territorial aspect, and therefore the tax regime we are concerned with consists mainly of

54. Personal jursidiction taxes the taxpayer on all income on a worldwide basis, irrespective of the personal link, both with regard to corporations and individuals. Thus, for example, personal jurisdiction over individuals in the United States is mainly on the basis of citizenship, whereas in Canada and England it is mainly based on residence. However, in all three countries, all income of those taxpayers who comply with the relevant connection is liable to tax. *See supra* note 6 and accompanying text. The same rule applies in the Netherlands. Corporations resident in the Netherlands are subject to income taxation on a worldwide basis on all their income. *See* SPENKE & LIER, *supra* note 9, at 59.

territorial jurisdiction, together with a personal jurisdiction which is extremely narrow in its scope. The latter jurisdiction applies to two insignificant situations, both from the point of view of their economic importance and from the point of view of their importance on the plane of social equity. Their economic importance is negligible both because of the low amount of tax that can be recovered thereby and because of their minimal effect on efficiency or economic growth. Their influence over the aims of social equity is also negligible, again owing to the small extent of tax recoverable in connection therewith. Collection of tax in this area does not, for example, in any considerable degree promote equality in distribution of income in society. Income from business abroad of Israeli residents, who normally engage in trade in Israel, is very limited. The same is true of wages earned abroad by Israeli residents employed by other Israeli residents. Furthermore, even if liability for tax under the control and management test is considered part of personal jurisdiction, such jurisdiction does not imply jurisdiction on a worldwide basis over corporations that are resident in Israel. This is for two reasons: First, personal jurisdiction does not apply to all corporations resident in Israel, because corporations, regarded as resident in Israel under the test of their main activity and place of registration are not taxed on a worldwide basis, but only on their income produced in Israel; and second, corporations resident in Israel under the control and management test are liable to Israeli income tax only on income from business, not on all of their income.

The exceptions to territorial jurisdiction, meaning tax events under personal jurisdiction, are not derived from any clear legislative approach as to the legitimacy to be accorded to personal jurisdiction. Rather, they are the result of special circumstances connected therewith. The aim of the provision regarding taxation of income from occupation is to prevent persons engaged in a particular occupation who operate in Israel but who also carry out work abroad from arguing that their income accrued abroad. For this reason, the rule of identity of occupations was laid down to eliminate the risk of escaping territorial jurisdiction when engaging in another occupation. The other exception is not based on "pure" personal jurisdiction, since liability to tax is dependent on the employer being an Israeli resident. "Pure" personal jurisdiction means the creation of tax liability on the basis of the residence of the income producer, not that of the payer of the income. The legislature saw fit to tax that income despite the normal territorial conception since under such circumstances all concerned were Israeli residents and should therefore be taxed. However, no general conclusion as to personal jurisdiction can be derived therefrom, nor can this be regarded as personal jurisdiction in the full sense of the term. Moreover, there is no general statutory provision that all income paid to Israeli residents by other Israeli residents should be liable for tax. This is only the case with regard to a very small segment of income from labor in view of its special character, in particular with regard to workers employed by governmental or quasigovernmental bodies.

The existence of a very limited personal jurisdiction leads to an undesirable outcome from the point of view of economic efficiency under the capital export neutrality principle, as well as from the point of view of social equity. Personal jurisdiction applies only to yield from human capital, in view of the fact that the only income liable to tax on the basis of personal jurisdiction is income from personal labor and not from all kinds of such income. Thus, liability for tax on a personal basis in respect to only a part of a person's income from human capital where the yield therefrom is liable to tax on the basis of personal jurisdiction, because the yield after tax on activity liable to tax on the basis of personal jurisdiction is lower in comparison with such yield on activity not liable to tax on that basis. An illustration of this point is relevant here.[55]

For example, two alternative scenarios may exist in which economic activity is carried on abroad. The first is by a taxpayer whose income abroad is from an occupation in which he is generally engaged in Israel, while the second is by a taxpayer whose income abroad is from an occupation in which he is not generally engaged in Israel. Even assuming the first scenario is more economically efficient in a given case, the second option will be preferred as a result of partial personal jurisdiction, although it is inferior from an economic point of view. The same applies to income from labor earned abroad by an Israeli resident employed by another Israeli resident. Again, two alternatives exist for such activities. The first is by an Israeli resident employed by an Israeli resident. The second is by a foreign resident employed by an Israeli resident or by an Israeli resident employed by a foreign resident.[56] The first alternative involves a tax liability, but the second does not, so the taxpayer will choose the latter even if it is less efficient overall.

Social equity, in the context of the distribution of the tax burden, also suffers a setback where personal jurisdiction is only partial. Horizontal equity is harmed because taxpayers with the same economic potential will bear differing tax burdens, depending on the structure of their income. The greater the relative weight of the component of foreign income not subject

55. For the purpose of these examples, foreign tax liability is ignored under the assumption that only Israeli income tax applies.

56. This is all on the assumption that the income is not liable to tax under the Income Tax Ordinance § 5(1), that is that it is not derived from an occupation usually carried on by the taxpayer in Israel.

to personal jurisdiction within the overall income, the more serious the harm to horizontal equity. Moreover, vertical equity may also be affected: Taxpayer A, whose overall income is worth less than that of taxpayer B, may nevertheless bear a heavier tax burden, even in absolute terms, if A's local income, as well as A's income liable to tax by virtue of territorial jurisdiction, are greater than B's. From a broad perspective, personal jurisdiction in the Israeli income tax regime can be ignored and it can be established that the international jurisdiction of the income tax regime in Israel consists solely of territorial jurisdiction.

The limited scope of personal jurisdiction in Israel's international income tax regime is not the only example of the influence of the territorial-statist conception. Such influence is evident in other areas. These areas are characterized by elementary legislative arrangements, showing clearly what little importance the tax regime attaches to international jurisdiction on a personal basis. Two prominent features of personal jurisdiction — the definition of residence and credit for foreign tax — demonstrate this proposition.

A. *Definition of "Israeli Resident"*

As detailed above,[57] the definition of "Israeli resident" as applied to individuals is simplistic and derives from an outdated conception. The statute adopts the test of reasonable temporary absence without providing a substantial content for the concept of residence, leaving the shaping of the content of this fluid expression to the courts. The concept of residence is at the heart of personal jurisdiction, so the substitution of the courts for the legislature in filling the concept with content increases instability and uncertainty as to the scope of personal jurisdiction as applied to individuals. Clearly certainty and stability are of overwhelming importance in the realm of international taxation, and increased involvement of the judiciary at the expense of the legislature in such a fundamental issue as the definition of residence shows lack of sensitivity to international taxation on a personal basis.

Furthermore, this definition of residence was not designed to be used for purposes of personal jurisdiction but rather for territorial jurisdiction. Israeli taxation on a territorial basis differentiates between Israeli and foreign residents by granting various tax credits — known as "credit

57. *See supra* note 46 and accompanying text. For the element of "residence" in English law and its numerous difficulties, see, e.g., Levene v. I.R.C., 1928 App. Cas. 217 (appeal taken from Eng.); I.R.C. v. Lysaght, 1928 App. Cas. 234 (appeal taken from Eng.); Reed v. Clark, [1986] 1 Ch. 1; R. v. Barnet London Borough Council, ex parte Shah, [1983] 2 App. Cas. 309 (appeal taken from Eng.); Gubay v. Kington [1983] 1 W.L.R. 709.

points" — to Israeli residents only. Credit points are granted automatically on the basis of residence[58] and also on the occurrence of additional circumstances.[59] These credit points are intended primarily to create the tax threshold, i.e., the income ceiling, earnings below which would be exempt from tax. This threshold constitutes the basis of the progressive structure because it provides that an effective tax rate of zero percent applies to income up to a certain level. The main reason for not granting credit points to foreign residents is that the social and economic policy in favour of progressive taxation does not apply in the *full* sense to foreign residents because the policy of redistribution which finds expression in the progressive tax structure should not be applied fully to a foreign resident, part of whose income (that produced in his country of residence) is not taxed, and who does not belong to the society within which such income redistribution is sought. The definition of residence is for the purpose of granting credit points, implying that the taxpayer will wish to claim to be a resident of Israel. Were the definition intended for purposes of personal jurisdiction, the position would generally be exactly reversed: the taxpayer would not wish to be considered an Israeli resident. It follows, therefore, that the statute does not deal with the issue of personal jurisdiction with the thoroughness that would indicate a positive attitude towards such jurisdiction. Statutory treatment of the subject reveals an unambiguous policy in favour of exclusive territorial jurisdiction over income taxation.

B. *Foreign Tax Credit*

The inclusion of personal jurisdiction within the international income tax regime requires enactment of a regulation which would prevent double taxation resulting from conflict between personal and territorial jurisdiction. The classical mechanism for solving this problem is for the State of residence to grant the taxpayer a credit for the foreign tax he has paid to the State of origin. Such an arrangement exists in various double taxation conventions and in the internal law of many countries that unilaterally grant a credit for foreign tax even where there is no convention. Israel has also adopted the unilateral system of credit for foreign tax.

The Israeli arrangement allows the taxpayer the choice between two alternatives.[60] The first alternative is a credit for tax, such that the tax paid

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58. As to the granting of credit points only to Israeli residents, see Income Tax Ordinance § 34. A similar feature exists in the U.S. tax system, but instead of credit points, personal exemptions are granted.

59. *Id.* §§ 35(a), 36–40.

60. Income Tax (Double taxation Relief) Order (1964) (Isr.).

in both States should not exceed the tax that the taxpayer would pay on income earned in Israel. In other words, the taxpayer receives a credit for the foreign tax paid to the State of origin for purposes of payment of Israeli tax. The second alternative is for the taxpayer to pay tax on the income at the rate of twenty-five percent. The income referred to is the income before foreign tax, so there should be circumstances where the total sum of foreign tax and Israeli tax is lower than the taxpayer's marginal rate of tax. For example, if the taxpayer's marginal tax rate is forty-eight percent, and he earns income abroad amounting to one-hundred dollars which is taxable at the rate of ten percent, the overall tax rate of the taxpayer does not exceed thirty-five percent. This rate is not consistent with the efficiency principle of capital export neutrality or with the principles of equity,[61] as reflected in the first alternative, as taxpayers with the same income bear different tax burdens, depending on where the income was produced. Because the overall tax rate (foreign tax and Israeli tax) is lower than the marginal rate of tax of the taxpayer on local income, the larger the taxpayer's income from abroad, the more serious the breach of those principles. Thus, the second alternative available to the taxpayer is regressive in nature, since the higher the marginal rate of Israeli tax appropriate to the taxpayer, the greater the tax benefit inherent in the reduced tax rate of twenty-five percent. The second alternative shows a clear lack of political certainty on the part of the legislature regarding the personal basis for tax liability, because if the legislature had taken the view that taxation of income on a personal basis was fully justified, only the first alternative would be appropriate.

One should completely reject the argument that the delay in development of an international income tax regime based on personal jurisdiction originates in the lack of development of international trade which, as a rule, requires the inclusion of personal jurisdiction in the international taxation regime, unless the principle of capital import neutrality is adopted. Israel has highly developed international economic activity, making the complete, or almost complete, lack of personal jurisdiction even more remarkable. One should likewise bear in mind that Israel's tax regime is highly developed in several respects such as the adjustment of the tax system to inflation. It follows that the lack of development of the international income tax regime cannot be attributed to a lack of general development in the tax system. Furthermore, the view that the Israeli system is confined to territorial jurisdiction because of its acceptance of capital import neutrality should also be rejected. Israel has never had, explicitly

61. *See supra* part I.

or otherwise, a policy of such neutrality; indeed, foreign investors enjoy far reaching benefits on their income produced in Israel.[62] These benefits are also granted under certain conditions to Israeli investors, thus bringing about a substantial erosion in territorial jurisdiction and in capital import neutrality. Moreover, if we take the lack of personal jurisdiction together with the erosion of territorial jurisdiction owing to the above-mentioned benefits, the result is that the tax burden is distributed in an unfair and inefficient manner among a relatively restricted group of taxpayers who produce their income under territorial jurisdiction which is incomplete.

The explanation that failure to adopt personal jurisdiction derives from a policy in which the international income tax regime is calculated to bring about an increase in economic growth by not taxing activity abroad, is also unacceptable. Comprehensive nontaxation of foreign activity, without differentiation between different categories of activity and their degree of connection with economic growth, does not encourage economic growth. Furthermore, the tax system grants relief to exporters by means of tax relief on economic activity *in* Israel that results in exports. Exportation is one of the important variables which determine whether a particular type of activity is to be given priority and deserves tax relief.[63] Incentives for export thus take the form of the tax benefits already mentioned. Israel's need for investment does not support the creation of a tax regime which encourages foreign investment by local residents and neglect both local investment and foreign investment in Israel. Fiscal policy embracing a formula which on the one hand grants tax relief to foreign investors and on the other hand gives tax relief to income produced abroad cannot be ruled out, but such policy should not be a comprehensive one. Rather, it should apply in very rare circumstances, so that only income serving economic and/or social aims is granted tax benefits. The present position of overall exemption for most categories of income does not conform to reasonable policy considerations, especially considering that the tax liability of certain income from human capital on a personal basis does not reasonably conform to considerations of economic growth.

The only conclusion is that reliance on territorial jurisdiction follows from a political outlook which greatly emphasizes territoriality. This political outlook, together with other factors, has created a situation in which foreign investments by Israelis are constantly expanding. Thus, for example, 1991 investments by Israeli residents abroad totalled $630

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62. For these benefits, see, e.g., Gliksberg, *supra* note 26.

63. *See* Encouragement of Capital Investment Law, § 1(2), 13 Laws St. Isr. at 258.

million, as compared with only $170 million in 1990.[64] This increase of 232% was derived mainly from expansion of international trade, and from partial removal of currency control regulations, thereby exploiting the international rules of jurisdiction over income taxation.

The territorial-statist conception of Israeli legislation is expressed in another topic, namely the eligibility of Israelis abroad to vote in Knesset elections. Under the Knesset Election Law (Consolidated Version), 1969, Israelis who are abroad are not eligible to vote in elections for the Knesset unless they are fulfilling functions on behalf of the Government of Israel.[65] Israel has thus adopted a territorial approach in the sense that the right to vote can only be implemented within the territory. There exists an alternative approach, the personal one, as in the United States, whose citizens can vote anywhere they happen to be at the time of the elections. Adoption of the territorial system and rejection of the personal system, reflects, once again, the territorial conception in the Israeli statist philosophy. A certain connection can be detected between the topic of international income tax jurisdiction and that of Knesset elections, in the sense that any person with economic capability who does not share the burden of financing governmental expenses should not have the right to participate in the democratic process. This can also be reversed: Anyone not entitled to participate in the democratic process of a particular society should not have to bear the tax burden of that society. The parallel between the obligation to pay tax and the right to vote is exceedingly complex, requiring separate treatment. Two comments are nevertheless relevant in this context.

First, under existing law, taxpayers who are not in Israel at the time of the elections are not entitled to vote abroad, even if they are liable to Israeli income tax under territorial jurisdiction and they do not produce any income abroad. In other words, there is no consonance in the definition of "territoriality" in these two regulations.

Second, adjustment between the right to vote and the obligation to bear the tax burden constitutes a serious problem with regard to foreign

64. *Israeli Foreign Investments in 1991 total $630 Million.* HAARETZ, Mar. 3, 1992, at C-1.

65. Section 6 of the Knesset Elections Law [Consolidated Version] (1969) provides: "There shall be no voting except within the land area of Israel, in Israeli vessels, and in embassies and consulates of Israel; this provision shall not apply to voting under Chapter Nine."

From the wording of the above provision there is nothing to prevent Israelis who are abroad from voting at Israeli embassies and consulates abroad, but Chapter 10B provides that only employees of the State of Israel or of a few additional entities (the Jewish Agency, the World Zionist Organization, the Keren Kayeemet Le Israel, and the Keren Hayesod), including their families, can vote at the above mentioned places. Seamen are also allowed to vote aboard vessels. Chapter 9 of the above law, mentioned at the end of section (6) deals with the Defence Forces.

residents who are liable to tax under territorial jurisdiction, but do not have the right to vote. As a result, foreigners are not able to participate in or influence the legislature, despite the fact that they incur the tax burden of society. This issue belongs to a wider discussion relating to the adjustment between the range of participants in the democratic process and the extent of those subject to it. From the point of view of the application of the law, there are numerous situations where foreigners will be subject to the norms of a particular State, although they are denied any right to vote. However, one could differentiate between participation in the democratic process and subordination to the law of the particular State. Taxation from a constitutional point of view is a serious infringement of the right to property and to a great extent is a potent expression of the connection of the taxpayer to the taxing State.[66] It follows that the lack of adjustment is more significant in the context of tax laws than in other areas.

From the above discussion, it thus emerges that the Israeli statist-political philosophy brings about a lack of adjustment of the international income tax regime to international economic activity and offends the principles of social equity. Israel's geopolitical situation, which results in the element of territoriality taking a central place in its political culture, carries with it not only the classical political, economic, and cultural influences, but also additional subsidiary influences which prima facie go beyond the radius of that intricate situation. A prominent example is the topic discussed in the present article.[67]

CONCLUSION

The present article examines the effect of the statist-political philosophy on the international income tax regime, and for this purpose the article has dealt with the Israeli model. The classical approach holds that economic efficiency, equity, and economic growth make up that regime. From the Israeli model one can learn that the political conception has a decisive influence in this matter. That conception not only affects the location of the equilibrium among efficiency, equity, and economic growth, but it also causes those considerations to make way for a purely territorial political outlook. Placing international jurisdiction over income taxation

66. For the connection between these two topics and for constitutional aspects connected with the various tax jurisdictions, see, e.g., the Note referred to *supra* note 3, at 119.

67. The article does not wish to minimize the other difficulties inherent in the international regime of income taxation. Thus, for example, there are no substantive statutory provisions with regard to the topic of transfer pricing — neither its theoretical aspects, nor the aspects relating to enforcement. On this, see, e.g., Richard L. Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299.

on a purely territorial basis brings about distortions from the point of view of efficiency, equity and economic growth. The present article, forwards the view that the present situation, with all its drawbacks, is derived from Israel's territorial, statist-political philosophy. In other words, the Middle East conflict has many and varied influences, which sometimes appear very remote. The subject dealt with here is an example of the fact that the statist-political attitude is liable to have a negative influence, consciously or not, on the formation of public policy, in general, and on the tax system, in particular.